Free State of Bavaria
Rating Report

SCOPE AAA STABLE OUTLOOK

Credit strengths

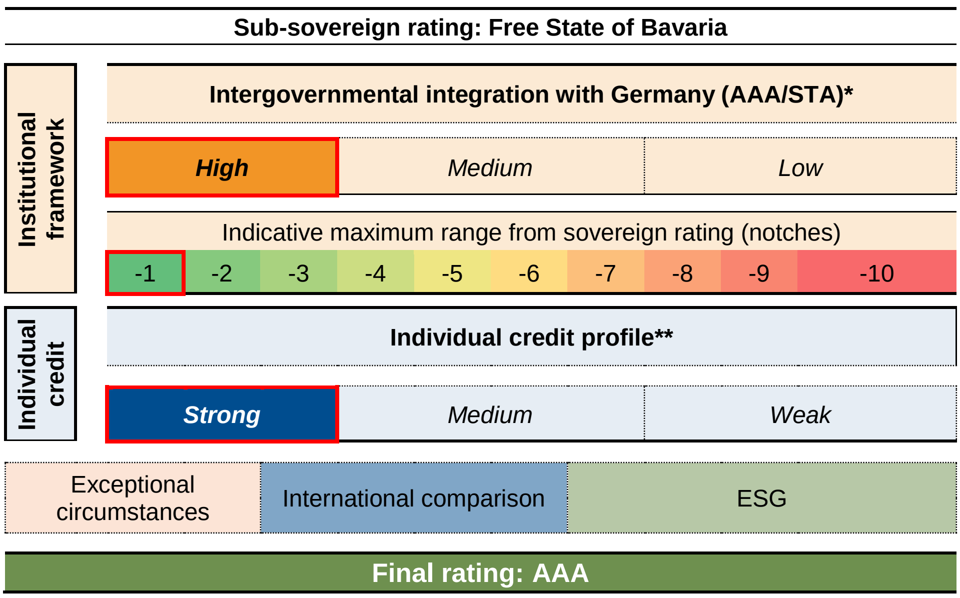
- Wealthy economy
- Strong budgetary performance
- Low debt burden
- Ample liquidity
- Excellent capital market access
- Highly integrated institutional framework

Credit weaknesses

- Limited revenue flexibility
- High pension liabilities
- Sizeable, though largely low-risk, contingent liabilities

Rating rationale and Outlook: The AAA rating reflects the Free State of Bavaria's exceptionally strong individual credit profile, captured by a wealthy economy, strong budgetary performance, low debt burden, ample liquidity, and excellent capital market access. In addition, the rating is underpinned by a highly integrated institutional framework, characterised by a very strong revenue equalisation system together with the federal solidarity principle. Credit challenges relate to limited revenue flexibility and high pension liabilities weighing on long-term expenditure flexibility, as well as sizeable, yet manageable, contingent liabilities. The Stable Outlook reflects our assessment that the risks Bavaria faces remain well balanced.

Figure 1: Scope's sub-sovereign approach to the rating of the Free State of Bavaria



*Across countries/government layers (German Länder) **Across national peers (German Länder)
Source: Scope Ratings GmbH

Positive rating-change drivers

- Not applicable

Negative rating-change drivers

- Downgrade of Germany's sovereign rating, necessitating a rating review
- Changes in the framework, resulting in weaker individual credit profile

Ratings & Outlook

Foreign currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

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Bloomberg: SCOP

Institutional framework

Integrated framework results in strong alignment of creditworthiness

The Free State of Bavaria, like all Germany's Länder, benefits from a mature, highly predictable and an integrated institutional framework. The key elements are: i) a strongly interconnected revenue equalisation mechanism enshrined in the German constitution; ii) wide-ranging participation- and veto-rights by the Länder in national legislation; iii) equal entitlement of the Länder regarding negotiations on federal reforms; and iv) a solidarity principle that ensures extraordinary system support in situations of budgetary emergency.

We view the federal system under which the German Länder[1] operate to be the strongest integrated system among European sub-sovereigns. We assess the system as 'high' for: i) institutionalised support; ii) fiscal interlinkage; and iii) political coherence, both among the Länder as well as between the Länder and the federal government. Consequently, our assessment results in a minimal indicative downward rating distance of at maximum one notch between the German sovereign (AAA) and the rating of the individual Land (see **Figure 2)**.

Figure 2: Framework assessment

Institutional framework assessment: German Länder

Category	Weight	Sub-weight		Assessment: Integration	Score	Weighted score
Institutionalised support	*50%*	*25%*	Transfer & bailout regime	**High**	100	25
		15%	Borrowing limits	**High**	100	15
		10%	Funding support	**High**	100	10
Fiscal interlinkage	*35%*	*20%*	Tax authority	**High**	100	20
		15%	Fiscal equalisation	**High**	100	15
Political coherence	*15%*	*10%*	Distribution of powers	**High**	100	10
		5%	Common policymaking	**High**	100	5
				Integration with the sovereign	**Σ**	***100***

Integration score	0-10	10-20	20-30	30-40	40-50	50-60	60-70	70-80	80-90	90-100
Indicative notch range	0-10	0-9	0-8	0-7	0-6	0-5	0-4	0-3	0-2	0-1

Source: Scope Ratings GmbH

Institutionalised support

➢ Transfer & bailout regime

We assess the integration of sub-sovereigns as 'high' when there is a constitutional and effective bailout rule, and/or a legislative procedure that allows for rules-based financial support in situations of budgetary emergency. Conversely, we assess a credible no-bailout framework and/or past debt crises as 'low' for integration, while ad-hoc financial support qualifies for 'medium'.

The constitutional court has legitimised financial support from the federal government to the Bundesländer in two instances: Bremen and Saarland (1992)[2]. The court approves claims on the grounds of the 'Bundestreueprinzip', under which the Länder and the Bund are required to provide each other with mutual support in the event of a budgetary emergency. Berlin's claim in October 2006 was denied, with the court arguing that the city-state was not in an extreme budgetary situation. However, the judges noted that

[1] We use 'state' and the colloquial German terms interchangeably to refer to German federal states, individually as ´Land' and collectively as 'Länder'.
[2] Editor's note: The above section was corrected on 23 July 2019 following the publication of the credit rating on 12 July. The original wording was: Länder have been granted additional financial support from the federal government in five instances: Bremen (1992, 2006), Saarland (1992, 2005) and Berlin (2002).

federal emergency support remains possible as ultima ratio if the budget and/or debt situation is assessed as extreme compared to that of other Länder.

We consider the interpretation of the 'Bundestreueprinzip' to be an implicit bail-out rule, as it requires the provision of federal support in times of budgetary stress. We therefore define the degree of integration as high.

- Borrowing limits

Second, we assess intergovernmental integration as high if permanent, quantitatively specified, legally binding and credible borrowing limits for central and regional governments exist. Otherwise, we assign medium or low integration if deficit rules have limited credibility, i.e. are self-imposed, inappropriate, and/or non-existent.

Debt brake to be implemented in 2020

From 2020 onwards, a 'debt brake' will become binding for the Länder[3]. Under this rule, no Länder will be allowed to run structural financing deficits unless hit by a severe economic downturn or a natural disaster. The debt brake will also cap the annual deficit of the central government at 0.35% of GDP.

The finances of the Länder and their compliance with debt limits is monitored by the Stability Council, which was established in 2010 as a joint body of the German Federation and the Länder. The Stability Council monitors restructuring programmes and compliance with budgetary targets as defined in fiscal consolidation agreements between the Bund and the Länder. The Council comprises the finance ministers of each Land and the federal ministers of finance and economic affairs.

We view the Stability Council and the debt brake as important pillars for integrated financial relations between central and regional German governments, which leads us to assess integration as high.

- Funding support

The third criterion on institutional support relates to the degree of mutual funding support. A history of common funding and/or equal risk weights with autonomous funding lead us to assess integration as high. A medium or low level of integration is characterised by either federal dominance on sub-sovereign funding or autonomous funding under separate risk weights.

Equal risk-weights combined with autonomous funding

We assign a high level of integration between the Länder and the federal government based on their history of stand-alone capital market issuance combined with aligned risk weights to the sovereign.[4]

Fiscal interlinkage

- Tax authority

First, we assess the degree of intergovernmental integration based on the division of tax authority. The higher the degree of shared decision-making on taxes, the higher we assess the level of integration across jurisdictions. One-sided dependence leads to medium integration and a complete separation of tax authorities leads to a low assessment of interlinkage.

Shared tax authority with the Bund on high-revenue taxes

The Länder and the federal government share the tax authority, deciding together on

[3] The debt brake is a legal framework that prohibits structural deficits from 2020 onwards; article 109 (3) of the Basic Law stipulates that the Länder may incur deficits in a case of a recession or a natural disaster provided they pass respective legislation at the Land level.
[4] Regulatory treatment of a sub-sovereign exposure in comparison with respective sovereign exposure for banks, which, in the European context, is defined under the European Banking Authority's Capital Requirements Regulation (CRR).

rates and revenue distribution on high-revenue taxes (income and VAT). The latest reform on federal financial relations in 2017 will result in a higher distributed share of VAT revenues to the Länder from 2020 onwards. The VAT distribution will also fully compensate for the different taxing powers, thereby replacing the former two-step process of horizontal equalisation payments between the Länder. Alongside common taxes, the central government and the Länder have separate tax authority on other less-revenue-generating taxes.

We assess the tax authority as highly integrated, based on the high share of common taxes and the clear separation of tax authority on less-revenue-generating taxes.

- Fiscal equalisation

Second, we assess the extent of fiscal equalisation. Legal rules to lower differences in living standards lead to a high assessment of interlinkage. Predictable redistribution payments to cover mandatory spending justify a medium while unpredictable or ad-hoc transfers lead to a low assessment.

Bavaria is the largest contributor to the equalisation system

The German system is shaped by a mechanism that strongly aligns different fiscal capacities among the regions. Bavaria is the largest net contributor to the system (EUR 6.67bn in 2018[5]), with most other Länder being net beneficiaries (12 out of 16) to prevent political and economic division. Taken together, the system ensures a minimum fiscal capacity of 99.7% relative to the average fiscal capacity per taxpayer across regions. We therefore assess the system of fiscal equalization as contributing to high integration.

Political coherence

- Distribution of powers

First, we assess the degree of political coherence between government levels based on the distribution of powers. High (medium) integration is characterised by the distinct (imprecise) distribution of responsibilities. Low integration is assigned if relations are shaped by frequent conflicts and persistent separatist movements.

Federal reforms further strengthen the high level of political coherence

In 2017, the German government and the Länder agreed to reshape financial relations in the federal system, generally binding from 2020. In return to higher payments from the equalisation system, the regions assigned limited executive and legislative rights to the central government in formerly autonomous policy areas, including physical and digital infrastructure and the higher-education system. In conformity with earlier federal reforms ('Föderalismusreformen II'), we observe that the higher the share of common national legislation ('konkurrierende Gesetzgebung'), the more integrated the German federal system becomes.

- Common policy-making

Second, we assess the degree of common policy-making as high if legislative processes require high co-ordination between government levels. Conversely, a medium (low) assessment reflects one-sided dominance (unilateral control by central government) in legislative processes.

The high share of common national legislation and the increasing political and financial involvement of the central government in regional policy areas lead us to assess the degree of common policy-making as high.

Special role of Bavaria with regional party

In addition, Bavaria has a unique role in the national political landscape. It is the only federal Land with a separate party: the Christian Social Union, or the CSU. The CSU has

[5] Preliminary calculation provided by the Federal Ministry of Finance in January 2019

been in power since 1957 under different coalitions but usually as a one-party government and has always appointed the Land's prime minister. The party also has a long-standing agreement with the Christian Democrats (CDU) to co-operate in federal and regional elections. While the CDU does not compete with the CSU in Bavaria, the two parties form a common parliamentary party on the national level. The CSU's ability to represent Bavaria's interests at the national level increases Bavaria's influence on national policy-making relative to the other Länder.

Individual credit profile

We assess Bavaria's individual credit profile as 'exceptionally strong' in view of the state's[6] ability to maintain balanced budgets and cover debt repayments, even under adverse conditions. This reflects Bavaria's: i) low debt, ample liquidity, and excellent capital market access; ii) strong budgetary performance and above-average expenditure flexibility along with average revenue flexibility compared to other German Länder; iii) wealthy and highly competitive economy; and iv) the high quality of governance at the regional level.

Our qualitative assessments are also informed by our core variable scorecard (CVS), which highlights that Bavaria has the strongest individual credit profile among the German Länder, underpinned by exceptionally strong financial indicators and good budgetary results with high investment levels. Its GDP per capita is one of the highest in Europe while its unemployment rate is the lowest in Germany. Finally, Bavaria's governance indicators compare favourably in both a national and international context.

Our qualitative and quantitative assessments are summarised in **Figures 3 and 4.**

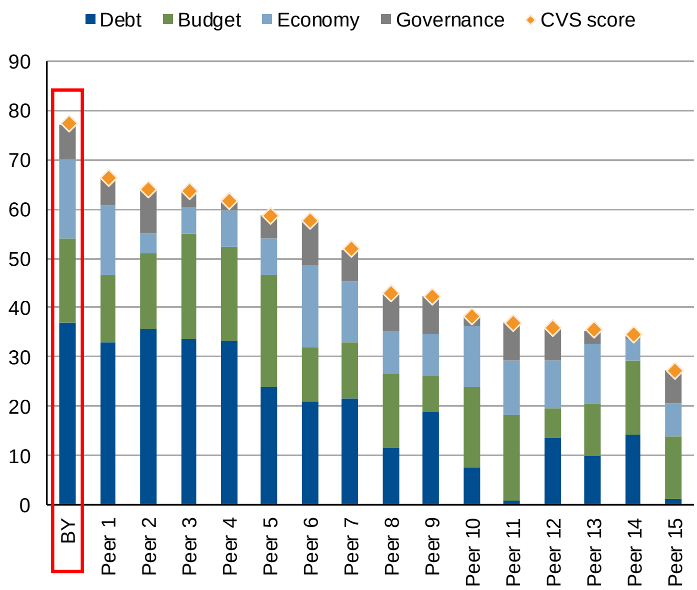
Figure 3: Qualitative scorecard (QS) result

Individual credit profile – qualitative assessment (QS)

Category	Weight	Qualitative scorecard	Risk: Low	Risk: Medium	Risk: High
Debt burden and liquidity profile	*40%*	Debt profile			
		Contingent liabilities			
		Funding and liquidity			
Budget performance and flexibility	*30%*	Budget management			
		Expenditure flexibility			
		Revenue flexibility			
Economy and social profile	*20%*	Growth & diversification			
		Labour & demographics			
Quality of governance	*10%*	Recent events & policy risk			
		Transparency/accountability			

Source: Scope Ratings GmbH

Figure 4: Core variable scorecard (CVS) result



Source: Scope Ratings GmbH

Debt burden and liquidity profile

High own cash reserves

The Free State of Bavaria benefits from ample liquidity, which supports the continuous reduction of its already low debt burden. Bavaria holds sizeable cash holdings vis-à-vis national peers, stemming from its sound budgetary and financial management. Bavaria's ample cash holdings are comfortably covering debt service through 2020. Moreover, the

[6] We use 'state' and the colloquial German terms interchangeably to refer to German federal states, individually as 'Land' and collectively as 'Länder'.

recent increase in cash reserves took place along an increase of postponed credit authorisations[7].

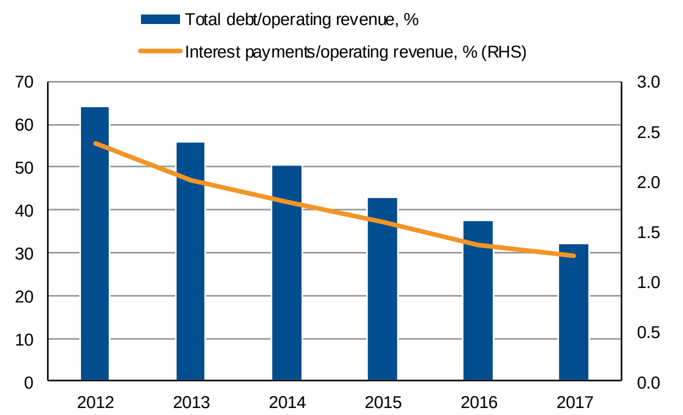
Solid cash flow profile and conservative liquidity planning

Bavaria benefits from highly predictable cash flows and prudent budgetary assumptions for liquidity planning. The state's cash flows, especially inflows, are prone to seasonal variations driven by the tax calendar. Similar to other Länder (excluding city-Länder), Bavaria's cash reserves tend to increase over the year, with peaks in mid-July and mid-October followed by significant outflows at the end of October and November. Moreover, the Land accumulates the Bavarian municipalities' shares in taxes before distributing them to the municipalities every quarter. These factors partly explain the state's excess liquidity during the year.

Excellent access to external liquidity

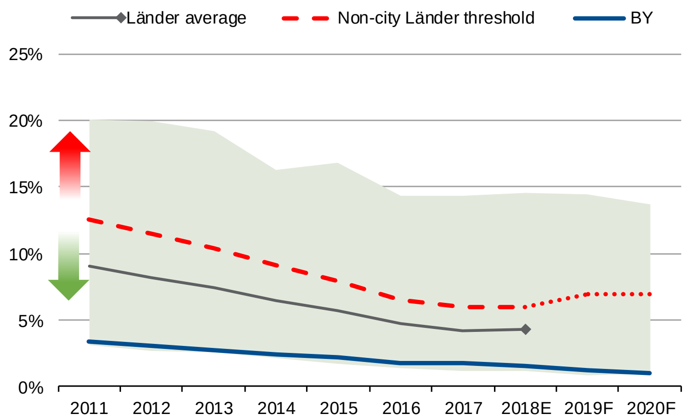
Bavaria has excellent access to external funding, which further strengthens its resilience to shocks. Access to external liquidity, if required, is available at short notice via credit facilities from various major financial institutions. In addition, German Länder lend excess liquidity to each other via commercial cash transactions, generating another source of liquidity. Combined with Bavaria's own sizeable reserves, this makes the risk of a liquidity shortfall negligible.

Figure 5: Debt and interest burden



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings GmbH

Figure 6: Interest-to-adjusted-tax ratio



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings GmbH

Low debt burden and continuous debt reduction

Bavaria benefits from a low debt burden in a national and international context and has repaid all maturing debt without recourse to credit authorisations in recent years. In 2012-18, Bavaria significantly reduced its direct debt to EUR 15.9bn of direct debt (excluding postponed credit authorisations), or to 25% of operating revenue, down from 64% in 2012. We expect the debt burden to continue to decline, to around 15% of operating revenue by 2022, as Bavaria has budgeted EUR 3bn for debt repayment in 2019-22. This will also result in further declining debt service, strengthening Bavaria's fiscal position.

Low interest-payment burden

The reduction of debt has led to a fall in Bavaria's interest payments relative to operating revenues, to 1.3% in 2017 from 2.4% in 2012, further bolstering its fiscal position (see **Figure 5**). Based on recent stability council assessments, Bavaria will continue to outperform most German Länder in terms of fiscal indicators, thus comfortably meeting the 'debt brake' rule. This view is also supported by Bavaria's very low interest-to-adjusted-tax ratio (see **Figure 6**) vis-à-vis national peers.

Sound debt management

As for all German Länder, we assess Bavaria's access to capital markets as excellent.

[7] In view of Bavaria's high own cash holdings combined with the low interest rate environment, a major instrument for reducing high cash holdings is the postponement of credit authorisations, which rose to EUR 11bn in 2018 from EUR 10.1bn in 2017. This means that authorisations to accept debt for the repayment of due loans are initially unused and due loans are settled using existing cash holdings.

This was most evident during the last financial crisis, when all Länder maintained their excellent access, demonstrating investor confidence in the German framework. In addition, Bavaria also employs a prudent debt-management strategy, with no foreign currency exposure, limited interest rate risks and a relatively long maturity of its direct debt. The latter also reduces refinancing risk. Going forward, in view of the low interest rate environment, Bavaria's debt management strategy foresees i) the issuance of fixed-rate debt only; and ii) the exclusion of new derivatives to minimise risks and maintain low administrative costs in debt management.

Materialisation of contingent liabilities unlikely

Challenges relate to Bavaria's sizeable implicit contingent liabilities arising from its 75% shareholding in BayernLB (total assets of EUR 220bn in 2018). As a positive development, financial risk from the state's exposure was reduced in 2017[8] after BayernLB repaid its state aid in full. Moreover, the repayment of Bavaria's capital contribution in 2017 lead to an early conclusion of the related EU proceedings. Dividend distributions to the owners of EUR 175m from 2018 were however still exceeded by anticipated interest payments of around EUR 250m in 2019 from outstanding debt to bail-out the bank. The bank's balance sheet is strong with a comfortable CET1 capital ratio of 15.2% in 2018, well in excess of the regulatory requirement.

Outstanding contractual guarantees issued by Bavaria have been declining, reaching around EUR 5bn in 2018. Guarantees primarily relate to: i) social housing (EUR 3bn); and ii) individual authorisations (EUR 2bn). In addition, Bavaria's strong management of its shareholdings is reflected in overall good financial results, indicating a low risk of materialisation of related contingent liabilities.

Budgetary performance and flexibility

A track record of strong budgetary performance and flexibility

Bavaria benefits from strong budgetary performance, with high operating surpluses averaging 12.8% of operating revenues in 2012-17 and significant surpluses before debt movement averaging 3.9% of total revenues (see **Figure 7**). This performance is underpinned by the strong growth in tax revenue, continuous cost control and conservative budgetary management, which have helped towards a substantial reduction in debt and a build-up of cash reserves.

Bavaria continues to outperform budget

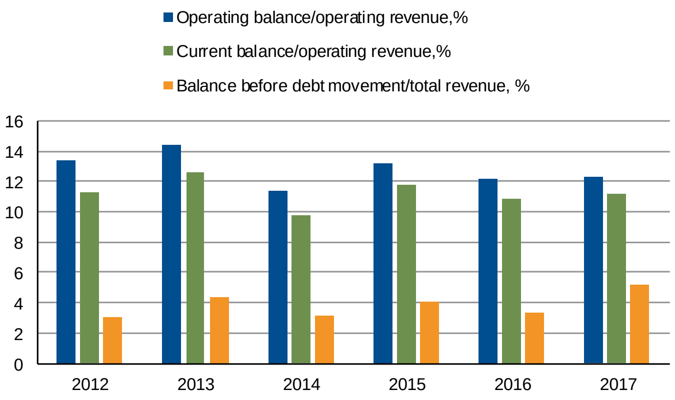
Based on recent tax estimates and in view of Bavaria's conservative budgetary management, we expect the state to significantly outperform its 2018 budget, driven by strong tax revenue growth (+8.6% year over year). Other operating revenues are likely to decline slightly due to the 2017 base effect when Bavaria recorded a EUR 1bn repayment from BayernLB, which was partially compensated for by a EUR 800m fine received from Audi AG in 2018. Therefore, we forecast a further improvement in Bavaria's budgetary performance for 2018, with an operating surplus of around 15% of operating revenues (from 12.3% in 2017) and a sizeable surplus before debt movement of around EUR 4bn (7% of total revenues) from around EUR 3bn in 2017 (5.2% of total revenues).

Operating revenue is driven by strong national growth

Bavaria's operating revenue is dominated by taxes (see **Figure 8**). As most taxes are subject to revenue equalisation, Bavaria mainly receives shared taxes (largely personal income taxes, value-added taxes and corporate taxes), thereby limiting revenue flexibility. These revenues initially are collected by Bavarian tax offices but are later redistributed at national level in accordance with revenue-sharing agreements and additional transfer mechanisms. This weakens the link between the state's tax revenues and its economic performance.

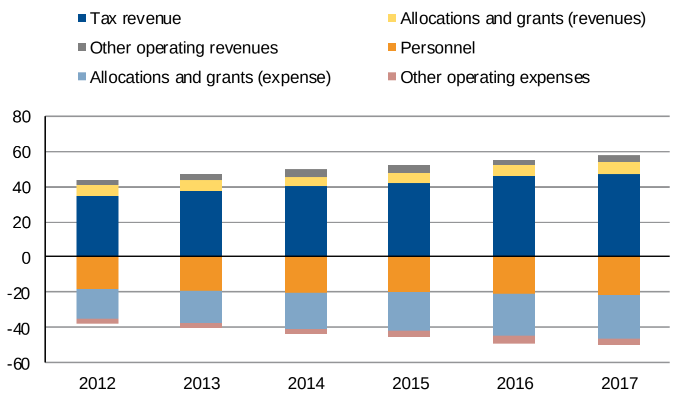
[8] In 2008/2009, Bavaria injected EUR 10bn of capital into the bank and issued EUR 4.8bn in guarantees for Bayern LB's structured finance portfolio. Under the EU state-aid proceedings, the EU Commission has scheduled a repayment of EUR 4.96bn until 31.12.2019 at the latest. With the repayment of EUR 1bn as of 30.06.201, BayernLB has fully met the repayment obligation. The guarantees for the structured credit portfolio were terminated in 2014.

Figure 7: Budgetary performance



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings GmbH

Figure 8: Components of operating balance (EUR bn)



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings GmbH

Above-average expenditure flexibility vis-à-vis peers

Bavaria enjoys low administrative costs (6.5% of expenditure in 2018). The state also has a track record of fiscal consolidation and implementing cost-cutting during economic downturns to offset budgetary shocks. However, the expenditure structure is rigid: Around 40% is dedicated to personnel costs (around 60% of which is spent on education, science, research and culture, and 20% on security and legal protection) and around 44% to transfers and grants, including transfers to Bavarian municipalities.

Pension payments weigh on long-term budgetary flexibility

With the number of eligible pensioners set to rise to 178,400 in 2040 (by 44% since 2014), pension expenditure will take up an increasingly larger share of Bavaria's budget, weighing on the state's long-term expenditure flexibility. According to Bavaria's report on future pension expenditure, which includes an alternative assumption on adjustments of the pensions by 2%-3% p.a., the share of pension expenditure will rise steadily from 8.95% in 2013 and peak between i) 10.9% during 2027-31 (with a growth rate of 2% p.a.) up to ii) 13.5% during 2039-45 (with growth rate of 3% p.a.).

To ease the rising pressure from unfunded pension obligations, Bavaria plans to co-finance pension payments via: i) savings through increases in the retirement age and compensation levels; ii) continuous debt reduction, thereby generating some fiscal room; and iii): withdrawals from its pension fund. The capital stock of the pension fund was EUR 2.75bn at the end of 2018. In addition to annual fund inflows of EUR 110m until 2030, Bavaria contributes pension allowances (EUR 19.9m in 2018). Overall, the combined measures, including anticipated savings, will result in a moderate share of pension expenditure, peaking below 10% and thus in line with today's levels.

Record-high investment levels over the medium term, along with continuous debt reduction

According to Bavaria's financial plan for 2018-22 (see **Figure 9**), the state intends to increase its already high level of investment, from 12.4% of total expenditure in 2018 to 14.2% in 2022, and continue with significant debt reduction at the same time. The current balance after interest payments will cover around 70%-80% of the state's investment expenditure under its medium-term financial plans, which will support Bavaria in maintaining solid cash reserves and its goal of continued debt reduction. Bavaria's expenditure programme will focus on five key areas: i) higher support for families; ii) increased security; iii) education; iv) promotion of housing construction and public infrastructure; and v) health and care, also in response to anticipated demographic changes.

Figure 9: Financial planning

	2018	2019	2020	2021	2022
Financial planning (in EUR m)					
Current revenue	58,441	61,730	57,005	59,260	61,264
Capital revenue	1,734	2,160	1,497	1,328	1,139
Total revenue (adjusted)	60,175	63,890	58,501	60,588	62,403
Current expenditure	53,645	56,688	51,513	53,222	54,585
Capital expenditure	7,727	8,630	8,651	8,817	9,007
Total expenditure (adjusted)	61,003	64,917	59,766	61,639	63,193
Balance before debt movement	-828	-1,027	-1,265	-1,051	-790
Gross borrowing	1,823	2,681	1,626	415	571
Redemption	3,323	2,931	2,376	1,415	1,571
Net reserve movements	2,328	1,277	2,015	2,051	1,790
Ratios					
Investment quota (%)	12.4%	13.1%	14.3%	14.2%	14.2%
Current balance/current revenue (%)	8.2%	8.2%	9.6%	10.2%	10.9%
Current balance/capital expenditure (%)	62.1%	58.4%	63.5%	68.5%	74.1%

Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings GmbH

2019/20 budgets: 14th and 15th consecutive years without recourse to debt

Bavaria's budgets for 2019 and 2020, which are part of the financial planning, are based on: i) balanced budgets[9] without recourse to debt (for the 14th and 15th consecutive years); ii) debt reduction by EUR 1bn (EUR 250m in 2019 and EUR 750m in 2020); and iii) increased investment to a record high. In our opinion, Bavaria will continue to surpass initial fiscal targets in 2019 and 2020, benefiting from higher-than-budgeted tax revenues and further strengthening its solid cash position.

2020/21: Slowing growth in national tax revenue mitigated by individual strengths

In our opinion, the expected decline in tax revenue growth in 2020/21, which mirrors the national economic slowdown, is mitigated by Bavaria's: i) conservative budget management; ii) low and declining debt service costs; iii) possibility to adjust budgets in view of the high investment levels; and iv) economic and demographic outperformance vis-à-vis national peers.

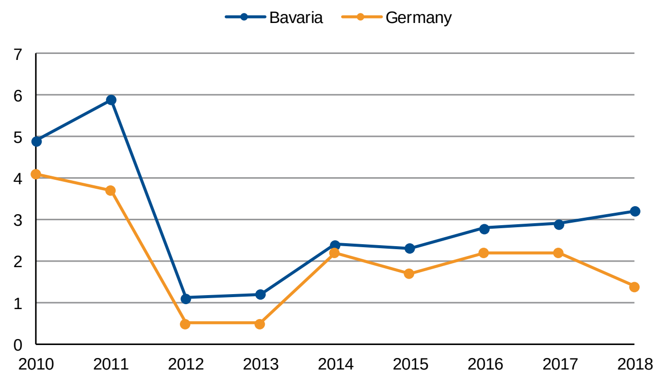
Economy and social profile

Key economic region in Germany

Bavaria has a favourable socio-economic profile underpinned by a large, wealthy, well-diversified and highly competitive economy, resulting in a high regional growth potential and strong ability to generate its own revenues for the long term. With GDP of around EUR 605bn in 2017, Bavaria is one of the key economic regions in Germany, contributing 18% of national GDP in 2018. Bavaria is also one of the wealthiest regions in Europe, with a GDP per capita outperforming both the German average, by 17%, and the euro area average, by 40%.

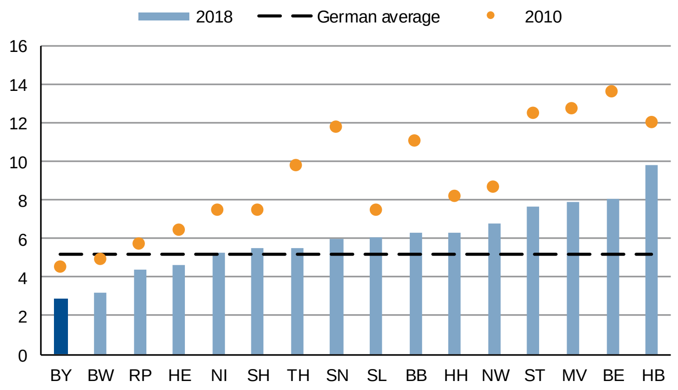
[9] Allgemeiner Haushalt

Figure 10: Real GDP growth, 2010-18, %



Source: Federal Statistical Office, Scope Ratings GmbH

Figure 11: Unemployment, % of total labour force, 2018



Source: Federal Statistical Office, Scope Ratings GmbH

Robust economic growth and highly competitive economy

Economic expansion has been strong, with real GDP growth averaging 2.4% between 2013 and 2017, exceeding the German average of 1.8% (see **Figure 10**). In 2017, Bavaria posted high real GDP growth for the fifth consecutive year, at 3.2% (vs. 2,2% national growth), reflecting the regional expansion in both the manufacturing and service sector. We expect GDP growth to soften in coming years but to remain above the German average. This assumption is based on i) Bavaria's recently stagnating exports, its high export share and global economic uncertainties, balanced with ii) the region's highly competitive industrial base driven by electrical and mechanical engineering and a booming regional property and construction sector.

Lowest unemployment in Germany

Bavaria enjoys favourable labour market characteristics and positive demographics, supporting its long-term tax revenue potential. Due to constant job creation, unemployment continues to fall, to 2.9% in 2018, and remains the lowest of the 16 Länder (see **Figure 11**). Regarding demographics, Bavaria has a relatively high ratio of working-age people (aged 15-64 years), at 66.2% in 2017. In addition, the Federal Statistical Office projects an increase in the total population by 3.7% until 2040 (assuming a nearly constant birth rate, a moderate increase in life expectancy, and higher immigration).

Quality of governance

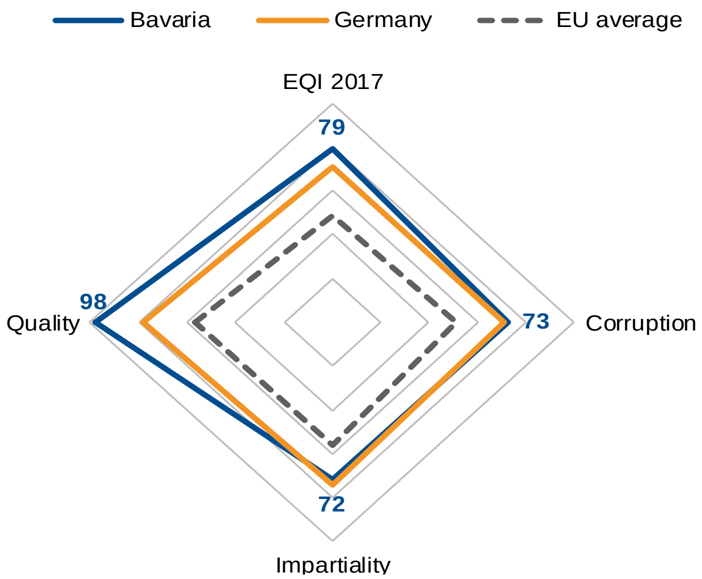
Stable political environment

We assess Bavaria's quality of governance and decision-making flexibility as strong. This is supported by the state's i) track record of nominal debt reduction; ii) regular fulfilment of policy objectives defined in strategic plans; and iii) ability to weather economic downturns by cutting costs to compensate for adverse budgetary developments. This view is underpinned by Bavaria's high scores in the European Quality of Government Index (see **Figure 12**), which captures the average citizen's perception of corruption in a sub-sovereign and the quality and impartiality of its public services. The outcome reflects Bavaria's outstanding performance in all key areas in both a national and international context.

Governing coalition of CSU/Free Voters

After losing their electoral majority in 2018, the Christian Social Union (CSU) reached a coalition agreement with the smaller, conservative Free Voters party to govern Bavaria. The CSU won 37.2% in the regional election, its lowest result since 1950. Under the coalition deal, the CSU's Markus Söder will remain the region's president, while the Free Voters will take over three ministries: economy, environment and culture.

Figure 12: EQI Index



Source: European Commission, Scope Ratings GmbH

Stable policy environment with a clear strategic focus

According to the coalition agreement, strategic priorities for the administrative term of Bavaria (2018-23) include: i) balanced budgets without recourse to debt; (ii) compliance with the debt brake mechanism starting in 2020; (iii) a strong commitment to become debt-free in the long run; iv) continued build-up of reserves. Given the commitment to continuous debt reduction backed by Bavaria's budgetary laws[10], we expect only limited changes to budgetary policies and debt strategy going forward.

Additional considerations

Review of exceptional circumstances

Our rating approach indicatively limits the maximum rating distance to the sovereign ratings, as established by our framework assessment. Following a review of potentially exceptional circumstances that cannot be captured by the quantitative and qualitative scorecards, we have not adjusted Bavaria's indicative rating of AAA.

International comparison

Bavaria's individual credit profile compares very favourably in an international context. This is supported by i) a low debt burden, ii) strong budgetary performance, including a high investment level; iii) very wealthy economy with low unemployment; and iv) strong governance indicators.

Long-term environmental and social risks

Alongside our assessment of rating-relevant credit risks, we consider long-term environmental and social developments. We assess developments regarding the German Länder by using selected sustainability indicators as defined by the German Sustainability

[10] Article 18, paragraph 1, section 2 of the BayHO

Strategy (DNS)[11], which itself is based on the Sustainable Development Goals (SDGs) set by the United Nations for 2030.

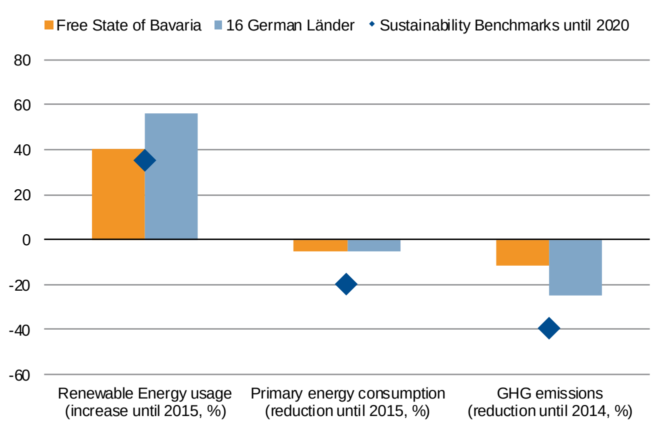
Relative underperformance on environmental benchmarks

With regards to environmental indicators, Bavaria remains below the average of German Länder in terms of greenhouse gas emissions, primary energy consumption and renewable energy use. The Land has also failed to meet DNS targets, particularly related to the reduction of greenhouse gas emissions (11% against a 40% benchmark). Although the latest figures are from 2014, Bavaria is unlikely to meet the benchmarks by next year (see **Figure 13**).

Outperformance on education; further action needed on gender pay gap

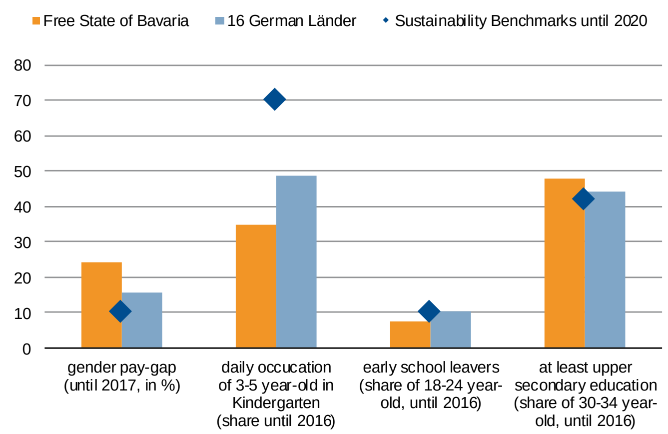
With regards to social indicators, Bavaria excels in educational attainment. The state outperforms the German Länder average not only in the share of early school-leavers but also in the proportion of students with at least an upper-secondary education. Bavaria has also outperformed on set benchmarks. At the same time, the Land fails to meet benchmarks on compatibility of family and career as well as on the gender pay gap (see **Figure 14**).

Figure 13: Long-term environmental risks



Source: German Federal Statistical Office, Scope Ratings GmbH

Figure 14: Long-term social risks



Source: German Federal Statistical Office, Scope Ratings GmbH

Methodology

The methodology applicable for this rating and/or rating outlook, Sub-Sovereign Credit Rating, published on 7 June 2019, is available on www.scoperatings.com.

Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerepweb/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

[11] https://www.destatis.de/DE/Themen/Gesellschaft-Umwelt/Nachhaltigkeitsindikatoren/Publikationen/Downloads-Nachhaltigkeit/machbarkeitsstudie-indikatoren-nachhaltigkeit-5911101159005.html

I. Appendix: CVS/QS results and mapping table

Individual credit profile: Free State of Bavaria

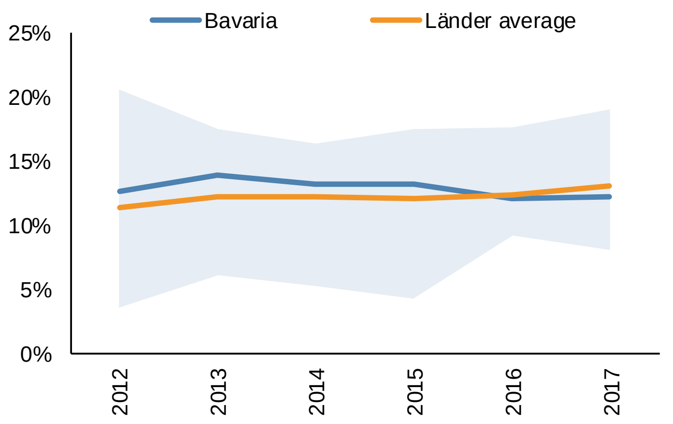
Category	Weight	QS	Risk	Score	CVS	Score	Weight	Total (CVS + QS)
Debt burden and liquidity profile	*40%*	Debt profile	Low	100	Interest, % operating revenue	100	*50%*	**96**
		Contingent liabilities	Low	100	Debt, % operating revenue	100	*25%*	
		Funding and liquidity management	Low	100	Balance before debt, % operating revenue	69	*25%*	
		Debt QS score	**Σ**	**100**	***Debt CVS score***	**Σ**	**92**	
Budget performance and flexibility	*30%*				Operating balance, % operating revenue	41	*40%*	**70**
		Budget management	Low	100	SD operating balance	94	*15%*	
		Expenditure flexibility	Low	100	Personnel expenditure, % operating expenses	11	*15%*	
		Revenue flexibility	Medium	50	Capex, % total expenses	72	*15%*	
					Transfers, % operating revenue	94	*15%*	
		Budget QS score	**Σ**	**83**	***Budget CVS score***	**Σ**	**57**	
Economy and social profile	*20%*				GDP per capita	84	*40%*	**91**
		Growth and diversification	Low	100	Unemployment rate	100	*20%*	
		Labour market & demographics	Low	100	GDP volatility	61	*20%*	
					Old-age dependency ratio	77	*20%*	
		Economy QS score	**Σ**	**100**	***Economy CVS score***	**Σ**	**81**	
Quality of governance	*10%*				Quality	100	*33%*	**85**
		Recent events and policy risk	Low	100	Impartiality	26	*33%*	
		Transparency and accountability	Low	100	Corruption	87	*33%*	
		Governance QS score	**Σ**	**100**	***Governance CVS score***	**Σ**	**71**	
						Individual credit profile	**Σ**	***86***

Indicative sub-sovereign rating			Individual credit profile: Strong ≥ 75	≥ 65	≥ 55	Medium ≥ 45	≥ 35	≥ 25	Weak < 25
			Indicative maximum notch adjustment from sovereign rating:						
Institutional framework: integration with sovereign	Full	0 - 1	0	0	0	-1	-1	-1	-1
		0 - 2	-1	-1	-1	-1	-1	-2	-2
		0 - 3	-1	-1	-1	-2	-2	-2	-3
	Medium	0 - 4	-1	-1	-2	-2	-3	-3	-4
		0 - 5	-1	-2	-2	-3	-3	-4	-5
		0 - 6	-2	-2	-3	-3	-4	-5	-6
		0 - 7	-2	-2	-3	-4	-5	-5	-7
	Low	0 - 8	-2	-3	-4	-4	-5	-6	-8
		0 - 9	-2	-3	-4	-5	-6	-7	-9
		0 - 10	-3	-4	-5	-6	-7	-8	-10

Source: Scope Ratings GmbH

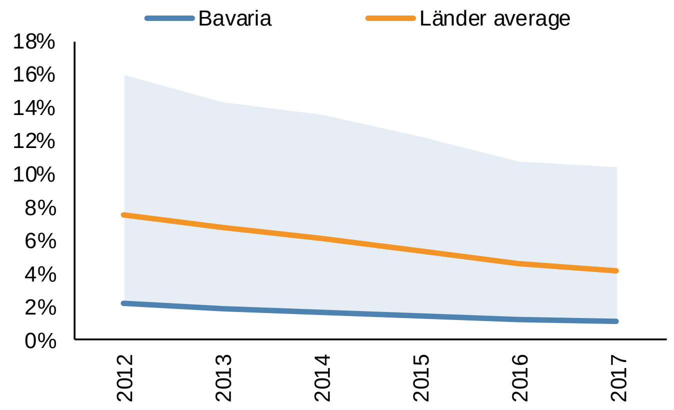
II. Appendix: Peer comparison

Figure 15: Operating balance/operating revenue, %



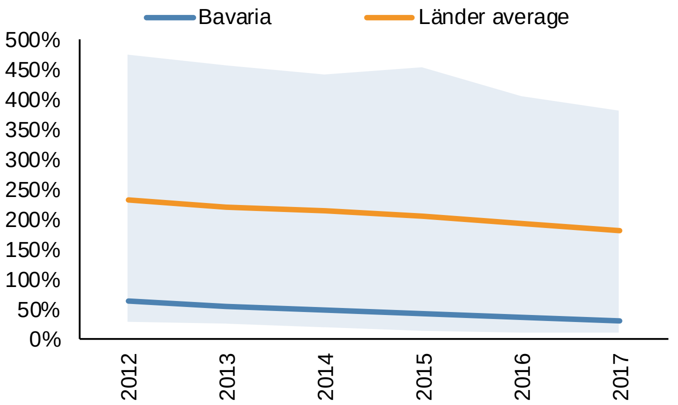
Source: Federal Ministry of Finance, Scope Ratings GmbH

Figure 16: Interest payments/operating revenue, %



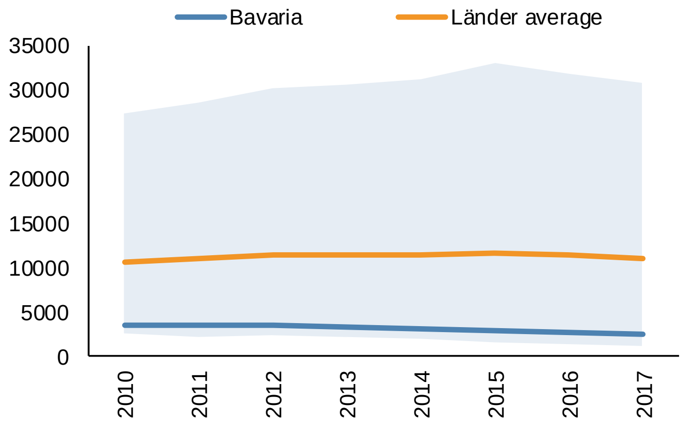
Source: Federal Ministry of Finance, Scope Ratings GmbH

Figure 17: Total debt/overall revenue, %



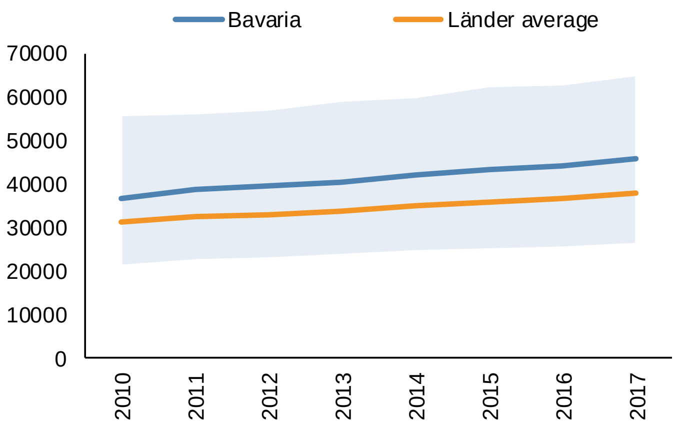
Source: Federal Ministry of Finance, Federal Statistical Office, Scope Ratings GmbH

Figure 18: Debt per inhabitant (EUR)



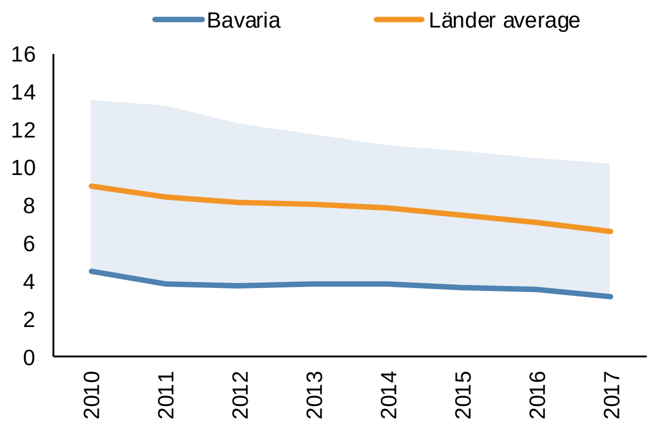
Source: Federal Statistical Office, Scope Ratings GmbH

Figure 19: GDP per capita (EUR)



Source: Federal Statistical Office, Scope Ratings GmbH

Figure 20: Unemployment (% of labour force)



Source: Federal Statistical Office, Scope Ratings GmbH

III. Appendix: Statistical table

	2012	2013	2014	2015	2016	2017
Financial performance	(in EUR m, unless noted otherwise)					
Operating revenue	43,708	47,323	49,593	52,440	55,355	57,178
Operating revenue growth, %	*5.3*	*8.3*	*4.8*	*5.7*	*5.6*	*3.3*
Tax revenue	35,292	37,623	39,709	42,143	45,900	47,097
Allocations and grants	5,466	6,250	5,868	6,267	6,477	7,015
Other operating revenue	2,950	3,449	4,016	4,029	2,978	3,065
Current revenue	43,812	47,395	49,672	52,514	55,419	57,253
Active interests	104	73	79	74	63	76
Operating expenditure	37,841	40,495	43,924	45,498	48,622	50,143
Operating expenditure growth, %	*4.1*	*7.0*	*8.5*	*3.6*	*6.9*	*3.1*
Personnel	18,083	19,028	19,804	20,283	20,984	21,861
Allocations and grants	17,119	18,639	21,162	21,944	23,838	24,499
Other operating expenditure	2,639	2,829	2,958	3,271	3,800	3,783
Current expenditure	38,884	41,450	44,816	46,332	49,374	50,864
Interest payments	1,042	955	892	834	753	721
Operating balance	5,866	6,827	5,669	6,941	6,734	7,035
Current balance	4,928	5,945	4,856	6,181	6,044	6,390
Capital revenue	1,431	1,545	2,139	1,534	1,570	2,663
Capital expenditure	4,962	5,358	5,375	5,518	5,683	5,956
Capital balance	-3,531	-3,813	-3,236	-3,984	-4,113	-3,293
Total revenue	45,243	48,941	51,811	54,047	56,989	59,917
Total expenditure	43,846	46,808	50,191	51,850	55,058	56,820
Balance before debt movement	1,397	2,132	1,620	2,197	1,931	3,097
Financial ratios						
Balance before debt movement/total revenue, %	3.1	4.4	3.1	4.1	3.4	5.2
Operating balance/operating revenue, %	13.4	14.4	11.4	13.2	12.2	12.3
Interest payments/operating revenue, %	2.4	2.0	1.8	1.6	1.4	1.3
Transfers/operating revenue, %	12.5	13.2	11.8	12.0	11.7	12.3
Personnel expenditure/operating expenditure, %	47.8	47.0	45.1	44.6	43.2	43.6
Capital expenditure/total expenditure, %	11.3	11.4	10.7	10.6	10.3	10.5
Debt						
Budget debt	21,565	20,565	20,025	19,525	19,525	19,525
thereof, direct debt	18,074	16,413	15,100	13,876	13,106	10,958
thereof, postponed credit authorisations	3,491	4,152	4,925	5,648	6,419	8,567
Stabilisation fund	10,000	10,000	10,000	10,000	9,450	8,950
thereof, direct debt	10,000	10,000	10,000	8,752	7,622	7,412
thereof, postponed credit authorisations	0	0	0	1,248	1,828	1,538
Postponed credit authorisations	3,491	4,152	4,925	6,896	8,247	10,105
Total direct debt	28,074	26,413	25,100	22,628	20,728	18,370
Overall risk	31,565	30,565	30,025	29,525	28,975	28,475
Debt ratios						
Total direct debt/operating revenue, %	64.2	55.8	50.6	43.2	37.4	32.1
Total direct debt/current revenue, %	64.1	55.7	50.5	43.1	37.4	32.1
Overall risk/operating revenue, %	72.2	64.6	60.5	56.3	52.3	49.8
Interest payments/total debt, %	3.7	3.6	3.6	3.7	3.6	3.9
Debt per inhabitant (EUR)	2249	2103	1985	1772	1608	1417
Economic performance						
GDP at market prices	494,015	509,084	530,417	553,662	578,315	605,390
Share in Germany's GDP, %	*17.9*	*18.0*	*18.1*	*18.2*	*18.3*	*18.5*
GDP per capita (EUR)	39,580	40,526	41,937	43,365	44,875	46,698
% of Germany's GDP per capita	*115.4*	*115.6*	*115.6*	*116.2*	*117.0*	*117.8*
Population ('000s)	12482	12562	12648	12768	12887	12964
Unemployment rate (% labour force)	3.7	3.8	3.8	3.6	3.5	3.2

Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Ministry of Finance, Federal Statistical Office, Scope Ratings GmbH

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